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November 30, 2005

Mr. Lawrence W. Smith
Director – Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: FSP FIN 46 (R)-c, "Determining the Variability to be Considered In Applying FASB Interpretation No. 46 (R)"

Dear Mr. Smith:

Merrill Lynch appreciates the opportunity to comment on the proposed FSP on FIN 46-R (the "FSP"). The consolidation guidance within FIN 46 is critical to many aspects of our business. Therefore, we have followed the progress of this guidance with great interest as any modification to FIN 46 is likely to have a significant impact on the accounting for many types of transactions.

In general, we do not support the issuance of this FSP as currently drafted. Although we understand the FSP is intended to clarify the current guidance, in many ways it adds an extra layer of complexity to what is already a difficult standard to apply. As we have noted in previous letters, many of the fundamental concepts that underlie FIN 46, such as variability in expected losses and expected returns, are not intuitive either to accountants or to business people who invest or otherwise participate in these transactions. As a result, we believe that the issuance of another FSP that is not immediately understandable may exacerbate rather than improve the current state of affairs.

Below we have provided some specific comments and recommendations that we hope you will consider, should you decide to proceed with the issuance of this FSP. We believe that these changes will make the FSP easier to apply.

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Qualitative Approach

In general, we believe that the concept of analyzing a VIE based on the design of the entity is theoretically sound. We also strongly support a move to a more qualitative analysis to determine the relevant variable interests ("VIs"), and ultimately the primary beneficiary ("PB"), as suggested in paragraph 14, as we believe that over-reliance on a quantitative analysis will at times produce counterintuitive results. However, we believe that it is important that the FASB explicitly acknowledge in this FSP that a qualitative analysis is inherently subjective, and as a result, different preparers can reach different conclusions regarding consolidation of a variable interest entity ("VIE").

Furthermore, although the FSP provides examples of how to perform a qualitative analysis to determine what the variable interests are, there are no examples of when a VI holder could reasonably conclude that it is not the PB based on a qualitative analysis. We recommend that the FSP include in the examples instances of when this might be appropriate. For instance, paragraph 13 states that the uncertainty absorbed by the substantive subordinated interest is strongly indicated as variability that is created by the design of the entity. Therefore, in example 2, a debt investor would likely draw a conclusion that it is not the PB. It would be helpful if the examples illustrated when an investor could reasonably arrive at this type of conclusion.

In addition, we note that there will still be many instances where a quantitative analysis must be performed to determine who is the PB of an entity. As the FSP acknowledges, both the fair value and the cash flow approach to quantitative analysis are used in practice today, and those approaches can lead to different conclusions where the impact of interest rates must be considered. We recommend that the FSP specifically acknowledge the use of different models for those instances when an investor must perform a quantitative analysis that includes the impact of changes in interest rates.

Determining the Design of the Entity

Paragraph 10 states that "the type of variability to be considered shall be based on the purpose for which the entity was created and the nature of the risks that the entity was designed to create and pass along to interest holders in the entity" (emphasis added). We believe that this statement commingles the concept of "purpose" and "design" in a somewhat confusing manner. For instance, the purpose of a VIE could be for a transferor to derecognize and/or monetize assets, to earn fee income from the efficient management/sale of assets, or to hedge the risk inherent in other assets. However, the examples provided seem to indicate that these types of reasons for creating the entity do not generally result in a conclusion that the transferor holds a VI in the entity, even though the transferor may derive benefits (i.e., by accomplishing its objectives) by transacting with the VIE.

Presumably, all parties to a VIE benefit from their interaction with the VIE in some way. Therefore, one cannot determine the design of an entity without also asking the question, for whom is the entity designed? We infer from the examples provided that the design of

the entity is to be determined from the perspective of the cash investors and, specifically, the subordinated investors -- because the investors are always shown as absorbers of risk in the diagrams. We believe this approach is supportable, because the investors who have put up cash are the ones with "skin in the game" and who therefore have something to lose.

In our opinion, in order to avoid confusion, the FSP should clearly state in paragraph 10 that an analysis of the purpose of the entity from a transferor's perspective should be used to provide insight into the variability that the entity is designed to create; and that VIEs are typically designed for cash investors and primarily for the subordinated investors. We believe this would go a long way in clarifying the guidance and helping users frame their analysis.

Developing a principle for treatment of simple interest rate and currency derivatives Based on our understanding of the FSP and the examples provided, it appears that in many instances, simple interest rate and currency derivatives are not considered VIs. Footnote 5 states:

"In the case of interest rate risk associated with periodic interest payments received or paid..., it may be appropriate to exclude such periodic interest receipts/payments from the variability to consider if the reporting enterprise determines that the entity was not designed to create and pass along interest rate risk...to its interest holders."

We expect that the result of this statement will be to reduce the instances in which simple market-based derivatives are considered VIs, and in our view, this is an appropriate result. However, we do not believe that the FSP has established a robust principle which can be applied in practice.

From the perspective of a financial services company, it is difficult to argue that VIEs are not designed to provide a certain interest return profile to investors. Investors expect a certain rate to compensate for the risk they are undertaking, and depending on the nature of the investor, certain payment streams are preferred. For instance, retail investors tend to prefer fixed-rate instruments and institutional investors often prefer floating-rate instruments. Although the interest return profile may be a secondary consideration for the investor, subordinate to the primary reason for which an investor invests in a VIE (e.g., to gain exposure to a particular credit in an efficient manner), we believe that it is oversimplifying matters to argue that the interest profile is not what the entity was designed to create.

Many industry participants have struggled with this issue. Intuitively, many believe that so-called "plain vanilla," at-market interest rate and foreign currency swaps should not determine or impact the consolidation result. In our view, a differentiating feature of these instruments is that the impact of interest rates and currency fluctuations on these

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instruments is purely market-driven, that is, external to the VIE. For instance, a simple interest rate swap with a VIE responds to changes in interest rates in the same manner as an interest rate swap transacted with an operating company of similar credit quality. In other words, if Merrill Lynch enters into a market interest rate swap that pays a fixed interest rate and receives a floating rate, that swap would behave in the same manner regardless of whether the counterparty is a VIE or a voting rights entity. This is also the case for simple currency derivatives. The swap is a market-based transaction that provides investors with a desired interest risk or currency exposure.

We do acknowledge that there are interest rate swaps that do more than modify the interest or currency exposure to investors. For instance, an interest rate swap could be designed to absorb any interest paid by the underlying assets and pay a fixed rate to the investors, regardless of the amounts received. In this instance the interest rate swap would not be valued like a simple interest rate swap because it is linked to the overall performance of the assets held by the VIE. This swap does more than convert the interest stream from fixed to floating -- it also provides liquidity to the investors.

It is our view that a principle could be developed that states that the first type of derivative, one that is based solely on changes in market interest rates, is a creator of variability. However, the second type of derivative described above would require further analysis. The principle could be that, to the extent that a derivative's only relationship to the VIE is to create a specific desired market interest or currency stream, which is at least *pari passu* to the most senior investor claim, the interest rate or currency swap creates variability in the entity because it creates a desired risk exposure for investors. We believe that the inclusion of a principle that can be easily applied to a variety of transactions will help issuers to better understand the guidance and how to approach these derivatives.

Further, we believe that a similar argument could be made to develop a principle for the analysis of the impact of market interest rate movements on VIs when performing either a qualitative or quantitative analysis of the entity. As noted above, the determination of the type of coupon or payment stream (e.g., fixed vs. floating, dollar vs. Euro) is generally a secondary consideration for an investor in a VIE. Though the entity is designed in part to provide this interest/currency exposure, that is not the primary exposure that drives the investment decision. We would argue that to the extent that an investor, either senior or subordinated, receives a stated market-level interest rate or currency exposure, the variability from changes in the market interest or currency rates should not be included in the analysis because those changes are based on factors that are external to the VIE. Since investors could recreate the risk/variability associated with general market interest/currency rates without investing in the VIE, that risk should not be considered a risk that the entity was designed to pass on to investors. This concept is alluded to in Example 1(b) paragraph A7.d., which states:

"The fair value of fixed-rate debt will fluctuate due to changes in market interest rates. Because that variability is not directly caused by changes in the value of the entity's net assets ..., it should not be considered when analyzing this entity."

We suggest this concept be expanded on and incorporated into the body of the guidance rather than relegated to one of the examples.

Treatment of interest rate swaps when the swap provider has other involvement

Footnote 8 states that "If a swap counterparty, directly, or through a related party, also held a debt or equity interest in the entity, an analysis of the design of the entity may lead to a conclusion that the swap counterparty was designed to absorb variability that otherwise would have been absorbed by the debt or equity investors, absent the swap transaction." We do not understand why a simple market derivative (as described above) that is senior to all other investor claims would be treated differently if entered into by the equity investor, debt investor, or any other VI holder. It is our view that if the derivative varies based on general market trends that are external to all other aspects of the transaction, and is senior to all other investor claims (as is often the case), the derivative should be considered to be a creator of variability, regardless of the counterparty.

On the other hand, if the derivative is embedded in the subordinated interests or subordinated to most other interests, we understand that the swap could be considered to absorb variability in the entity. The payment priority of the derivative helps determine if the derivative is used in the transaction simply to create a market interest rate profile desired by investors.

Also, it is not clear how to analyze these transactions when more than one investor is involved. For example, it is difficult to apply the guidance in Footnote 8 when the swap provider holds a portion of the equity. Assume, for instance, that the investment arm of a bank owned 15% of the equity of a VIE and the bank's derivative dealer entered into a simple market interest rate swap that was senior to all other investor claims. Further, assume that the equity is substantive. Following the guidance in Footnote 8, it appears the bank would be required to analyze the variability in cash flows arising from the senior swap in addition to its equity interest. Given the volatility in interest rates, under this analysis the bank may be required to consolidate the VIE, even though the equity is substantive, the bank holds substantially less than the majority of the equity, and the swap is senior in payment priority.

Based on the above, it is our view that market-based derivatives that are senior in payment priority should not be considered VIs, regardless of any other involvement that the derivative counterparty may have with the VIE.

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Inconsistency with FIN 46R

We are concerned that the FSP is inconsistent with paragraph B7 of FIN 46R. Paragraph B7 states that, "If the contract with the equity investor represents the only asset of the entity then that equity investment is not at risk." This guidance has been interpreted to mean that an investment that exposes the investor only to its own credit or performance risk is not a variable interest. This principle has been applied broadly in practice. For instance, Merrill Lynch has concluded that in instances where the only asset of the entity is a receivable from Merrill Lynch (e.g., as in transactions that do not meet the sale requirements of Statement No. 140), the transaction should be analyzed pursuant to the guidance in paragraph B7, and Merrill Lynch would not be considered a variable interest holder in the VIE.

Example 4 and FSP paragraph 9 seem to be at odds with this principle. Paragraph 9 states:

"In all cases, the role of a contract or arrangement in the design of the entity, rather than the legal or accounting classification of that contract or arrangement, should dictate whether that interest should be treated as creating risk for the entity or absorbing risk from the entity (that is, a variable interest)."

It is not clear how to apply this statement. For instance, if an entity transfers assets to a VIE and does not achieve a sale, the asset of the VIE, from an accounting perspective, is a receivable from the transferor. Paragraph 9 of the FSP seems to imply that this accounting classification should be disregarded and instead the "role" of the contract should determine its treatment. Although it is not clear what the "role" of the contract is, one could conclude from this that if the transferor is an investor in the entity, the transferor could still be exposed to variability arising from an "accounting" receivable to itself, or the receivable itself could be viewed to absorb variability. FIN 46R, paragraph B7, on the other hand, implies that the transferor would not be a VI holder because it is only exposed to risk created by a receivable from itself.

We believe Example 4 highlights this issue. Under Example 4, it seems unlikely that the furniture manufacturer would achieve a sale and derecognize the inventory under the guidance in Statement No. 49. Therefore, it is likely that the only asset of the VIE is a receivable from the furniture manufacturer, and that receivable has full recourse to both the furniture inventory and the manufacturer. Based on our current understanding of B7, the furniture manufacturer would not have a VI in the entity because the only asset it is exposed to is a receivable from itself. The debt investor would be a VI holder, and if there is only one debt investor, it would be the PB.

Although this is a somewhat theoretical exercise, given that the difference between consolidation and non-consolidation leaves both the investor and manufacturer in essentially the same position, there are times when following paragraph 9 of the FSP versus following paragraph B7 of FIN 46R could lead to different conclusions. It is our view that if there is guidance that establishes the accounting treatment for an asset (e.g.,

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Statement No. 140 requires certain transactions to be treated as secured borrowings), that guidance should be respected when performing the consolidation analysis. To do otherwise will cause further confusion in applying FIN 46R. We recommend, at a minimum, that Example 4 directly address the furniture manufacturer's and the VIE's accounting treatment of the transfer, as well as reconcile the guidance in paragraph 9 of the FSP to paragraph B7 of FIN 46R.

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Thank you again for the opportunity to comment on the ED. We hope that the Board will give serious consideration to our comments as they further deliberate this project. Please do not hesitate to contact me with any questions or requests for additional information.

Sincerely,

/s/ Esther Mills

Esther Mills
First Vice President